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General Business Conditions

THE reports of retail trade and industrial activity have continued good during October, while staple commodity prices, in contrast, have been easy. In earlier issues of this Letter we have commented upon the fact that although the country is experiencing a boom, it is fortunately a sober one. The familiar measures of economic activity are at record highs, whether they are physical quantities such as industrial production or dollar aggregates such as national income. The demand for labor is strong, wage rates are rising, and the reduced efficiency which results from employment of marginal workers and from excessive labor turnover — both characteristic of booms — is reported in many places. The productive capacity of the country is about as fully engaged as could be expected, if we take into account the limits of the labor supply, certain shortages in materials and parts, and the cases where the seasonal trend is down or overcapacity is chronic. Moreover, the financial signs of boom conditions, increasing debt, declining liquidity, and immense investment programs, are in evidence. The influence of the inflated government demands is visible almost everywhere.

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Nevertheless, both stock and commodity markets have been dropping. Among the usual ingredients of a boom, the spirit of speculation is the one that is lacking. Industrial purchasing agents are not reaching out with commitments, but mostly the contrary. Mercantile buyers have placed more orders than they had outstanding at this time last year, because their sales are up and inventories lower, but they are not taking particularly long positions. While consumer expenditures are at a record high, thrift and prudence are also being practiced, as seen in the savings figures and in the promotional effort that merchants find necessary to keep sales moving.

Inflation Fears Disappearing

Despite the prophecies of new inflationary price rises, which were so spectacularly voiced by the Government's economic stabilization officials only a few months ago, people seem to have made up their minds that inflationary influences have been discounted in the markets. Defense expenditures will increase over the next six to nine months, and the Federal Treasury is operating at a deficit. On the other hand, the events of the past year or more have demonstrated the ability of this country, with its immense productive capacity, to carry on defense work, increase its industrial plant, sustain a high level of consumption, and still pour out some kinds of goods in excess of the market's capacity to absorb them at the prices asked. For a long time it has been easy for consumers to find all the goods they want and can pay for. Industrial purchasing agents are not yet in that position with respect to all types of steel, copper and a few other things, but the trend is toward an easing of the shortages that still exist.

The rise in wage costs thus far has not lifted finished goods prices to the extent that the alarmists foresaw. The restraining influence is the need to set prices which will move goods. Under

competitive conditions manufacturers do everything possible to keep prices down, to raise productivity, to cut costs through redesign and simplification, to improve the product and make it more attractive at the price. Contrary to predictions, some of the 1953 automobile models are being priced lower than the 1952 offerings in the same lines. But efforts to offset wage cost increases cannot succeed everywhere, and concern about the effects of higher prices or shrinking margins on business is one of the elements in the present cautious feeling.

Apart from the markets, the detailed business reports for October have been favorable. Department store sales have improved both as compared with last year and with the seasonal expectation. The relatively poor showing of these stores in September, when their sales were 1 per cent below last year and failed to realize the usual seasonal increase, was not characteristic of total trade. Sales of all types of retail stores, according to the Department of Commerce, were 7 per cent above September 1951 and 4 per cent above August on a seasonally adjusted basis.

The Federal Reserve Board's industrial production index reached a new postwar high for September at 225 (1935-39 = 100). The Board estimates that the October index will rise another point, despite the interruption in coal mining. In the influences which are supporting business — rising defense expenditures, sustained construction, and industrial expansion and improvement — it would be hard to find any significant evidence of weakening. While buying in primary textile markets has slackened, mills have backlogs to keep them running. In soft goods business generally the fact that buyers have bought conservatively will bring them back to the markets in good time, assuming only that the influences sustaining employment and purchasing power continue effective. In view of the huge unfilled orders of the heavy industries, that assumption should be warranted for at least a number of months to come.

The Commodity Price Decline

The rise in staple commodity prices from the Korean outbreak to the peak in February 1951 averaged 48 per cent, according to the index of 28 staples compiled by the Bureau of Labor Statistics. At the end of the past month some nine-tenths of this rise had been retraced and 13 of the 28 commodities had dropped back to the pre-Korean level or lower. The principal declines during October have been in cotton and corn, reflecting large crops, and in lead and zinc.

A price reaction of this extent necessarily reflects general causes as well as specific influences in the various markets. During the post-Korean rise the demand for industrial materials was swollen not only by increased consumption, but by inventory accumulation and government stockpiling, here and abroad. The first check to the move came after stocks were built up or committed for, with resulting abatement of buying. Concurrently an increase in commodity supplies was under way, both as a natural response to higher prices and as a result of extraordinary efforts to increase production. New facilities were opened, for example the synthetic rubber plants and new mining operations, and the farms have produced large crops. New import restrictions in many countries have reduced demand in world markets.

In the earlier stages the price decline was most marked in materials entering into consumers' goods, and was part of the general consumers' goods slump. The materials used particularly in defense production, such as the metals, have been slower to reflect the general influences because direct and indirect defense uses were expanding and the shortages took longer to overcome. More recently the settling process has extended to the world markets for non-ferrous metals, and the repercussions have been largely responsible for the drop in lead and zinc in the domestic markets.

It would be hard to show, however, that final consumption of the metals is declining, for according to the Federal Reserve Board's indexes manufacture of durable goods in September and October reached new highs at 285 and 289 per cent, respectively, of the 1935-39 average. Producers of automobiles and household appliances have stepped up production sharply since the steel strike and are pressing for more steel in the first quarter of 1953. Along with more steel, they will use more nonferrous metals. In the defense industries inventories of materials and supplies are large, and a rise in demand proportionate to consumption is not to be expected.

Producers of the staple commodities lose purchasing power through the price declines, but there have been similar price reactions in the past, when demand otherwise was strong, without setting up a chain of deflationary consequences. Indications of the demand to be expected in the months ahead suggest that this is another such time. It is reassuring that the commodity price reaction in fact has run for twenty months, in terms of the price indexes, that it has been gradual and orderly and left few losses in its wake, and that the economy is now more

fully occupied than it was twenty months ago. The labor unions, however, should take warning. When the commodity producers are losing purchasing power for the products of factory labor, the hazards of a policy of forcing up costs and prices of finished goods should be plain. A sure way to reduce trade and create unemployment is to ask more for goods offered in the market, at a time when the income received by such an important segment of the population is declining.

Third Quarter Corporate Earnings

Corporate reports to shareholders issued during the past month indicate an improvement as compared with the second quarter of this year and with the third quarter of a year ago. Our tabulation of the published statements of 525 companies, representative mainly of the larger manufacturing organizations but including also numerous of the smaller manufacturers and a limited number engaged in the mining, trade, and service industries, shows combined net income of $1,141 million, an increase of 3 per cent over the preceding quarter and of 2 per cent over the third quarter of 1951.

One factor in the improvement was the rebound this year in general business activity, following the settlement of the steel strike at the end of July, and a resulting recovery in corporate earnings from the second to third quarters.

Another factor was the depression of net income in the third quarter of '51 as a result of the slow-up at that time in certain major lines of business, plus the retroactive increase in federal income tax rates approved October 20, 1951. This year some companies when reporting their 1952 earnings gave comparative figures for 1951 adjusted so as to distribute the tax increase over that full year, but the majority of reporting companies have made no revision of their previously published figures.

For the first nine months, decreased earnings were experienced by two out of three companies reporting. The combined net income of the group, amounting to $3,430 million after taxes, was 10 per cent below the same period of '51, and 17 per cent below '50, as may be seen from the following summary of the quarterly totals:

Net Income after taxes of 525 Leading Corporations

(In Millions of Dollars)

	1950	1951	1952	% Change 1951-52
First quarter	$1,146	$1,348	$1,180	—12
Second quarter	1,422	1,327	1,109	—16
Third quarter	1,558	1,124	1,141	+ 2
Nine months	4,126	3,799	3,430	—10
Fourth quarter	1,547	1,362		
Year	$5,678	$5,161		

Manufacturing corporation earnings this year have not held up as well, generally speaking, as has the dollar volume of sales. Although well over half of the reporting manufacturers were able to register at least some increase in sales, the size of the gains was insufficient to offset the advance in operating costs, with the result that net income declined. Among those companies whose sales fell short of last year's, net income in most cases dropped much more sharply, as, for example, in several branches of the textile and apparel industries.

A group of 34 iron and steel producers showed for the nine months a drop of 38 per cent in net

NET INCOME OF LEADING CORPORATIONS FOR THE THIRD QUARTER AND FIRST NINE MONTHS

(In Thousands of Dollars)

No. of Cos.	Industry Groups	Reported Net Income Third Quarter 1951	1952	Per Cent Change*	Reported Net Income Nine Months 1951	1952	Per Cent Change*
31	Food products	$ 25,649	$ 32,939	+28	$ 100,402	$ 94,634	— 6
10	Beverages	11,288	7,756	—31	28,459	21,746	—24
12	Tobacco products	13,139	13,709	+ 4	39,290	35,106	—11
34	Textiles and apparel	17,340	11,722	—32	82,869	25,811	—69
16	Paper and allied products	16,842	17,813	+ 6	64,183	51,767	—19
38	Chemical products	100,127	111,995	+12	373,033	336,900	—10
19	Drugs, soap, cosmetics	32,507	34,108	+ 5	103,115	96,616	— 6
32	Petroleum producing and refining	431,732	390,312	—10	1,216,314	1,192,152	— 2
20	Cement, glass, and stone	27,347	32,825	+20	94,426	87,975	— 7
34	Iron and steel	118,071	88,650	—25	443,608	273,020	—38
16	Building, heating, plumbing equipment	12,728	13,446	+ 6	51,581	36,271	—30
20	Electrical equipment, radio and television	33,369	69,512	+—	168,675	184,688	+ 9
36	Machinery	20,418	25,891	+27	74,292	83,526	+12
9	Office equipment	15,029	14,751	— 2	49,344	44,568	—10
13	Automobiles and trucks	95,066	122,716	+29	400,623	416,909	+ 4
23	Automobile parts	17,127	15,457	—10	61,257	54,548	—11
9	Railway equipment	9,842	10,160	+ 3	33,331	32,935	— 1
61	Other metal products	53,356	65,023	+22	190,305	176,469	— 7
35	Miscellaneous manufacturing	25,636	25,492	— 1	88,567	71,816	—19
468	Total manufacturing	1,076,603	1,104,277	+ 3	3,663,674	3,317,452	— 9
24	Mining and quarrying	27,801	18,505	—33	79,928	63,101	—21
22	Trade (retail and wholesale)	7,114	9,557	+34	24,332	23,157	— 5
16	Service and amusement industries	12,807	9,041	—29	30,994	26,015	—16
525	Total	$1,124,825	$1,141,880	+ 2	$3,798,928	$3,429,725	—10

* Increases or decreases of over 100% not computed.

income after taxes, caused mainly by the prolonged steel strike. Their reserves for federal income and excess profits taxes payable dropped during the same period by 74 per cent or approximately $650 million.

In other lines, however, numerous companies were able to make such substantial increases in sales this year that, combined with effective control over expenses, they were able to carry at least part of the gains through to net income. This was particularly true of many companies in such lines as electrical equipment (including radio and television), machinery and other metal products, automobiles, and aircraft, whose operations have been stepped up by the expansion of their output going to the national defense program, as well as by the correction of the excessive inventory accumulation and sluggish civilian markets for some of their products last year.

Profit Margins Squeezed

Of the 463 manufacturing companies in the group, the profit-and-loss details reported by a majority of the larger units show that aggregate dollar sales in the first nine months were approximately 2 per cent ahead of a year ago. Total costs, however, except taxes, advanced by 7 per cent, so that the balance before taxes was cut 20 per cent. Of such balance, the reserve for federal income and excess profits taxes payable decreased 26 per cent, and absorbed, on an average, 57 per cent, against 62 per cent a year ago. Net income after taxes was down 9 per cent, as shown by the following composite income account, which is partly estimated:

Sales and Net Income of 463 Manufacturing Corporations in the First Nine Months

(In Millions of Dollars)

	1951	1952	Change Amount	Change %
Receipts from sales, etc.	$53,275	$54,469	+1,194	+ 2
Total costs, except taxes	43,671	46,750	+3,079	+ 7
Balance before taxes	9,604	7,719	—1,885	—20
Fed. income & e.p. taxes	5,940	4,402	—1,538	—26
Net income after taxes	3,664	3,317	— 347	— 9
Taxes to bal. before taxes	62%	57%		
Net income per sales dollar	6.9c	6.1c		

The widely-observed general tendency of a squeeze on profit margins caused by costs advancing faster than selling prices is indicated by a narrowing of net income per sales dollar, from an average of 6.9 cents in the first nine months of 1951 to 6.1 cents this year. Such a slender net margin as now prevails does not afford much leeway for possible unfavorable changes, such as a falling off in sales, a forced cut in selling prices, or a further rise in costs. Under present high tax rates, of course, the Treasury has become the major "partner" in business and as such stands to offset more than one-half of any change—either increase or decrease—in operating income. Of the top layer of earnings, representing the "excess" as defined by law over an arbitrary base, the Treasury now takes 82 per cent.

Dividend Changes Mixed

Dividend payments, as tabulated by the Department of Commerce for all U.S. corporations reporting their declarations publicly, showed for the first nine months a dollar total 4 per cent higher than last year. The manufacturing industries as a whole were up 3 per cent, due mainly to an increase in the petroleum products group of 16 per cent. Among the divisions other than manufacturing, the dividends paid by mining corporations were up 13 per cent, public utilities up 8, banks and other financial companies up 5, and railroads up 3. Trade dividends were down 4 per cent.

These generally upward trends in the dollar totals of dividend payments make a more favorable showing than the corresponding figures on number of dividend changes as compiled by the New York World-Telegram and Sun. The favorable changes have, in fact, been comparatively the fewest, and the unfavorable changes the most numerous, in several years, as will be seen from the following totals.

	First Nine Months 1949	1950	1951	1952
Increased dividends	238	553	408	201
Extra dividends	696	932	858	588
Reduced dividends	195	51	47	122
Omitted dividends	187	79	49	115

Credit Supply and Demand

With Federal deficit-financing superimposed on other credit requirements, the money and capital markets this year are experiencing what may prove to be the heaviest aggregate demands since war financing was completed in 1945. On the other hand, the supply of savings, encouraged by higher interest rates, has been good and the degree of reliance on bank credit expansion has been less than in 1950 and 1951. Nevertheless, the tilt of the scales remains on the side of inflation, which will be a basic question for the new administration and Congress taking office in January. One point of attack is via Federal Reserve credit policy. Another is via the application of a judicious pruning knife to programmed Federal Government expenditures. Both Presidential candidates have advocated budget balancing and, as conditions permit, tax relief.

The following table gives estimates of changes in the three main categories of debt in the postwar years. No precise estimate of private debt

for 1952 is attempted but it may be noted that an increase of $33 billion – well within the range of possibilities – would put the total debt increase for the year up to $40 billion.

Changes in Net Public and Private Debt
1946 - 1952
(in billions of dollars)

Year Ended Dec. 31	Publicly held Federal Debt	Net State and Local Govt. Debt	Private Debt	Total Debt
1946	−23.1	+0.4	+14.7	− 8.0
1947	− 5.9	+1.8	+26.8	+21.7
1948	− 7.1	+1.9	+20.8	+15.6
1949	+ 2.3	+2.2	+ 7.4	+11.9
1950	− 0.3	+2.6	+36.4	+38.7
1951	− 0.4	+2.4	+30.8	+32.8
1952 est.	+ 4.5	+2.8		

Sources: For Federal debt, 1946-51, estimates of the Treasury Department; other debt, 1946-51, estimates of the Commerce Department adjusted where necessary to a calendar year basis; 1952 figures for Federal and State and local debt are tentative estimates by this bank.

As the table indicates, calendar 1952 is the second of the postwar years in which the Federal Government has borrowed from the public more than it has redeemed in publicly-held obligations. Liabilities to the old-age pension and other trust funds, accumulating at a rate of $3 to $4 billion a year, are not reflected in the table. These funds, borrowed as fast as they come in, were slightly more than enough to cover the deficit during the 1950 and 1951 calendar years. This year they are falling short to the extent of $4 to $5 billion. The main part of this deficiency was covered by the sale of $4¼ billion six-year bonds last July 1.

The Treasury has also had a large turnover of old debt requiring the sale or issuance of new obligations. In May the Savings bonds were made more attractive with the result of narrowing the excess of redemptions over new sales from $60 million to $30 million a month. The principal lenders to the Treasury this year have been business corporations and, to a lesser extent, foreign central banks and governments. In the former instance the funds mainly represent investment of tax and other liquid reserves. In the case of foreign central banks and governments the funds represent accumulation of currency reserves.

Record State and Municipal Borrowings

State and local government borrowings, for highways, housing, school buildings and a variety of other projects, have come at an accelerated pace this year, with extra stimulus in the spring from the withdrawal of the Voluntary Credit Restraint Program. It now seems probable that the increase in indebtedness of State and local governments this year will approach $3 billion, surpassing the previous record of $2.6 billion in 1950. State and local government indebtedness, which declined from $16½ billion to $13½ billion during the war, has doubled to $27 billion in the seven postwar years.

Because of their exemption from Federal income tax, obligations of State and local governments have had a strong appeal to commercial banks, which, unlike many savings institutions, are subject to corporate income taxes. Commercial banks have been absorbing close to half of new State and local government issues. Fire, marine and casualty insurance companies, individuals and personal trust funds account for the bulk of the remainder although other investor classes are being attracted by the relative generosity of the yields on an after-tax basis. Prices of municipal obligations, which advanced as a result of the 1950 and 1951 income tax increases, recently have been sagging under the weight of new issues coming to market and in October yields rose to the best levels in many years. The improvement in yields, providing returns as high as 2¾ or 3 per cent free of income tax, has produced the widening of the market necessary to absorb the increasing supply.

Private Borrowing

Private indebtedness this year is reaching up to new heights in almost all major categories although rates of increase are not uniformly of record proportions. Business corporations have increased their borrowings from banks but to a much smaller degree than in 1950 or 1951. This is evident from the figures of the weekly reporting member banks on commercial, industrial and agricultural loans. Such loans, which rose $3.9 billion in 1950 and $3.8 billion in 1951, are up no more than $0.6 billion through October 22.

On the other hand, sales of corporation bonds, to finance expansion of industrial and public utility facilities, seem headed for a new record. Life insurance companies, to a considerable degree through the channel of "private placement", have been the single largest point of support for the corporate bond market though pension funds and savings banks are also important market factors.

Farmers generally have been cautious in incurring mortgage indebtedness in the postwar period and the greater rise in farm debt has been in short-term production credits extended typically by the local commercial bank, by a supplier relying on bank credit, or by a federally sponsored lender.

In the field of mortgage credit, the outstanding feature continues to be the demand for urban home-building. The growth of mortgage debt on one-to-four family homes may exceed

$6 billion this year, following upon the record increases of $7.8 billion in 1950 and $7.1 billion in 1951. Life insurance companies and commercial banks are less active in the mortgage field than in earlier postwar years but savings and loan associations and savings banks have taken up the slack. These latter institutions have raised their dividend rates and are experiencing the best growth in resources since the war.

The extended rise in home mortgage debt has been aided by the suspension of Regulation X. The elimination of Regulation W affecting consumer instalment credit has had a more pronounced effect, although the easier availability of materials for building cars has also been influential. The volume of consumer instalment credit outstanding, substantially unchanged during 1951, has risen $1.6 billion since early May when Regulation W was lifted, very nearly as much as the $1.7 billion rise that occurred in the similar period of 1950 when consumer instalment credit had a record expansion of $2.6 billion for the year as a whole. Banks and finance companies are the principal factors in this business even though the borrower's point of contact may be with a merchant.

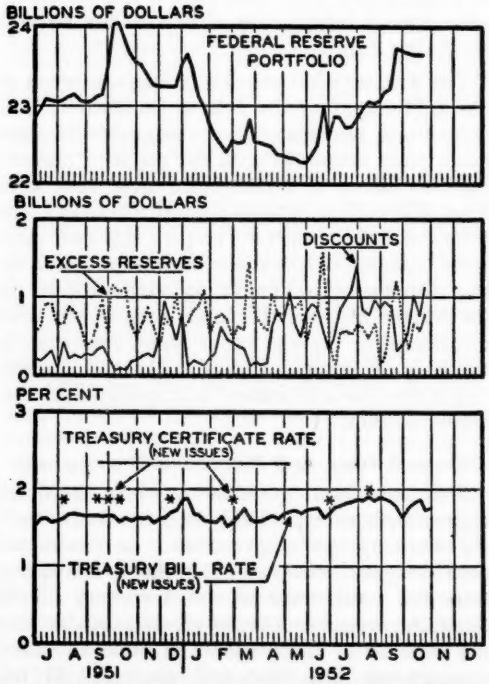
Relation to Federal Reserve Policy

Although aggregate credit expansion may make a new record for the postwar period, it is impossible to make any close estimate at this time of what the figure will be. Neither is it possible to state with any assurance how much more the expansion might have been if the government bond market had not been unpegged in March, 1951 restoring to the Federal Reserve a discretionary control over its loans to the Federal Government in the form of Treasury securities purchased in the open market.

The unpegging, which took guaranteed floors out from under government bond prices and allowed them to find their own levels in a free market, had a considerable shock effect. The unpegging had no sooner been completed than it became apparent that inflation had taken a respite, and Federal Reserve policy entered a phase of so-called neutrality. The discount rate was left undisturbed at the 1¾ per cent level established six months earlier in August, 1950.

Open market operations conducted by the Federal Reserve since the unpegging, however, do not fit any simple description of neutrality. In combination with natural market forces, they have given the money market alternate periods of ease and tightness, partly to accommodate the needs of Treasury finance, partly to observe effects, and partly to teach the market not to rely on the Federal Reserve to buy up government securities every time the money market comes under pressure, to use the discount window as an alternative, and to recognize that free markets in government securities involve opportunities for profit as well as risks of loss.

As the chart indicates, Federal Reserve holdings of government securities, at $23.7 billion on October 22, are $600 million higher than they were in July, 1951 when the adjustment to a free market basis for government bonds had been completed. In September 1951 the Federal Reserve entered the market to buy $1 billion government securities, as a means of facilitating Treasury and seasonal business borrowing. These transactions were largely reversed in October and November and the authorities dropped out of the market until the year-end when they bought briefly to relieve the acute year-end pressures for funds and then let their portfolio decline by a billion to offset the easing of the money market associated with the January-February return flow of currency to the banks. After some purchases in June, the Federal Reserve forced banks to borrow to accommodate market absorption of the $4¼ billion 2⅜ per cent Treasury bonds sold July 1. Purchases in August were



Federal Reserve Banks' Holdings of Government Securities, Member Bank Discounts and Excess Reserves, and Rates Paid by the Treasury on New Issues of Bills and Certificates of Indebtedness

comparatively modest and bank discounts held close to the $1 billion mark.

In September, as a year earlier, the Federal Reserve bought government securities, this time directly to assure success of an issue of 2⅛ per cent fourteen-month notes put out by the Treasury in exchange for maturing 1⅞ per cent certificates. These purchases, which ran to $600 million, produced the easiest money market since June and drove yields on 91-day Treasury bills below the 1¾ per cent discount rate. In October the authorities levelled out their government security holdings, as they had toward the end of 1951. At this writing, seasonal increase in demands for money and credit are pushing discounts up to the $1 billion zone again.

An Appraisal

The tactics pursued by the authorities, shifting unpredictably, have succeeded in maintaining a large degree of uncertainty and avoiding any set pattern of operation. The authorities themselves have had to follow something of a cut and try program to find out how various types of operations would react upon the market. The market, on its part, bereft of artificial price supports, has had to give deeper attention to the fundamentals of money and credit and to the implications of the swings and detours of official policy.

The most vital accomplishment of the year and a half of unpegged markets has been the reeducation of banks in the use of the discount window to tide them over periods of pressure in the money market. The reluctance of banks to borrow insures a closer scrutiny of credit need and purpose when discounts are high and rising. The power to raise the discount rate can be exercised at any time the authorities desire to reinforce the caution of the lender.

The period has furnished further evidence that credit policy can be an aid to economic stability but cannot do the whole job. It must be conducted with an eye to the state of the Federal Government's finances, and Federal Reserve activities, no matter how skilfully conducted, cannot compensate for a lack of balance in the budget. Unless the budget is scaled back, continuous deficit-financing is the prospect with all that implies in terms of cumulative inflationary pressure. Beyond that, pushing out some of the Treasury debt maturities — a process tentatively begun in the past year or two — can ease the handicap of an excessive floating debt to a flexible credit policy.

Trends in Japan

On October 1 the Japanese people, in the first national election since Japan became a free and sovereign nation, answered decisively the question of where they stood on the issue of collaboration with the free nations of the world or with Communism. In the largest turnout of voters in the national history, amounting to 76 per cent of the total eligible electorate (against a comparable figure of only 51 per cent in our own Presidential election of 1948), the people of Japan not only gave a majority to the Liberal Party of Premier Shigeru Yoshida, but gave the Communists a severe drubbing. The Communist popular vote, around 3 million in 1949, shrank to less than one million, or about 2½ per cent of the electorate. Whereas they held 22 seats in the old Diet, the Communists have none in the new one.

While the Liberal Party's representation in the new Diet was reduced, as shown below, and major opposition parties other than the Communists gained, this has little significance from the point of view of international policies. Both the Progressives and the Right Wing Socialists favored Japanese inclusion in the United Nations and the maintenance of a security pact with the United States, although the Socialists would have the agreement "basically" revised. The figures suggest that some of the Communist vote shifted to the Left Wing Socialists.

Party Standing in the Japanese House of Representatives

Party:	No. of Seats in Last Diet (a)	No. of Seats in New Diet
Liberal	285	241
Progressive	67	85
Right Socialist	30	57
Left Socialist	16	54
Communist	22	—
Cooperative	5	2
Labor-Farmer	4	4
Minor parties	4	5
Independents	4	18
Total	437	466

(a) The number of seats held at the time of dissolution in August 1952, when there were 29 vacancies.

At the first session of the new Diet Mr. Yoshida, Premier in 1946-47 and again for the past four years, who had worked sincerely and effectively with the Allied occupation, was reelected to that position. His cabinet appointments suggest a continuation of the policies of his previous administrations.

Revulsion Against Communism

The revulsion against Communism reflects in part Japanese resentment at Communist action at the last May Day riots, which revealed its subversive nature. Soviet resistance to Japanese participation in the United Nations and other international organizations, and the strongly

anti-Japanese tone of the Chinese-Russian agreement recently signed in Moscow, were other influences.

But deeper still, there is evidence that Japan has definitely turned her face toward the western world and the democratic way of life. The lesson learned in so tragic a way has not been lost. Not generally noted in the United States was the dramatic dedication of the monument to the victims of the Hiroshima bombing. "Sleep quietly — this mistake will never be repeated", reads the inscription. The addresses at the dedication ceremony made it clear that the "mistake" was for Japan to disturb the peace.

The significance of all this, both to the United States and to the free world, scarcely can be exaggerated. The Japanese are a disciplined, patriotic, literate people. Their military and industrial capacity has been demonstrated. The country has the potential for forming a strong anti-communist base in Asia.

But if Japan is to be a bastion against Communism she must have economic strength. She must achieve a self-supporting economy, capable of providing an adequate standard of living for her people. Her task is not easy. Rehabilitation from the war is far from finished, and economic and political conditions in her natural markets and sources of supply in China and Southeastern Asia pose serious obstacles.

Nature of the Recovery Problem

To begin with, there is Japan's dependence on foreign trade. Mr. Joseph M. Dodge, President of the Detroit Bank and former Financial Adviser to the Supreme Commander for the Allied Powers in Japan, stated the problem in general terms in a farewell message to the Japanese people at the conclusion of his mission in November 1951:

> Too many people, too high a birth rate, too little land, too few natural resources.
>
> This combination produces an increasing need for expanding overseas sources of food and the raw materials of production. With the need goes the requirement for payment.
>
> It is not the production *capacity* of Japan that is the key to survival, but the supply of materials out of which the goods and products essential to the life and future development of the economy are created and the efficiency with which they are processed and converted into export products acceptable in world markets.
>
> In the future, as in the past, the foreign exchange needed to pay for imports will have to come mostly from the exports of Japanese manufactured goods and products.

The disastrous war made these problems worse. The population which in 1937 was 70 million had increased by 1951 to nearly 85 million, partly due to the repatriation of some 5 million Japanese colonists, soldiers, and administrators from the lost empire. Though the birth rate is declining, so too is the death rate and the urgent problem of finding sustenance and jobs for some 700,000 to 1,000,000 more people every year remains. With the increase in population, the pressure on the available land is probably greater than ever before. Each acre of farm land in Japan must feed about 12 times as many people as in the United States. The dependence upon food imports has been growing.

At the same time the dependence upon raw material imports has also increased, largely as a result of the collapse of the colonial empire which left Japan in control of only about 48 per cent of the territory she held in 1937. The closing of former empire sources of raw materials and foodstuffs has weakened Japan's ability to pay her way, as did also the wartime destruction. Some 30 per cent of industrial capacity was bombed out. Additional capacity was lost by textile and other consumer industries through the melting of their machinery into scrap during the war. Of the merchant marine tonnage, an important earner of foreign exchange in prewar days, only about 20 per cent was left at the war end.

A Remarkable Comeback

Despite all the losses and the odds against her, Japan has staged a truly remarkable comeback. Today Japan is not only in better economic condition than was thought possible, but is economically and politically far more stable than most of the countries of free Asia.

Credit for the recovery should go first to the realism of Japanese statesmen, the resourcefulness and capacity of the business leaders, and the discipline and willingness of the people to work hard. But her recovery would have been much slower and social and political pressure more intense had it not been for American aid in the form of goods, food, raw materials, and American spending in Japan. Formal aid alone has aggregated some $2 billion, roughly equivalent to Japan's postwar trade deficit up to almost the end of last year.

Progress of recovery may be divided into three distinct phases. The first phase lasted from the end of the war until the spring of 1949. In that period, the first confused and hesitant steps were taken towards rehabilitation, but production did not begin to expand steadily until late in 1947 when the Occupation authorities accented recovery rather than reform. The supply of goods remained low, and as inflationary pressures held

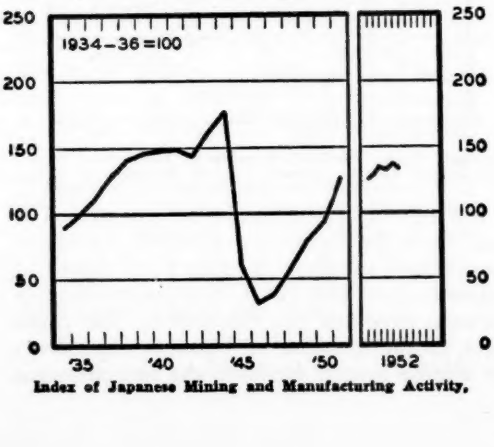
down during the war were released, and were augmented by huge government spending for pressing rehabilitation needs, violent inflation ensued with wholesale prices increasing over 50 times.

The second phase began with the inauguration of the Dodge Stabilization Program in the spring of 1949. Deficit financing was halted, a single exchange rate established, local government budgets balanced, hidden subsidies drastically reduced or eliminated, government participation in private economic activity curtailed, and many controls abolished. Budgetary surpluses were used to retire a substantial part of the government debt, and further reductions were achieved by the use of yen counterpart funds arising from the sale of U.S. aid imports. Complementing the work of the Dodge Mission, a U.S. Tax Mission under Professor Carl Shoup of Columbia University undertook a program of revising the Japanese tax system with a view to making taxes more equitable and more easily collectible.

These reforms, courageously carried out by the Japanese Government and the Central Bank, reestablished a basis for sound money and brought a check to inflation.

The third phase of Japan's recovery opened with the outbreak of the Korean war. The opportunities created in world export markets and the provision of services for the United Nations troops in Korea brought about a great spurt in industrial activity and relative prosperity. This, together with renewed expansion of bank credit and money supply, and sharp increase in raw material costs, restimulated inflationary pressures and lifted prices generally to new peaks.

At the outbreak of the Korean war, Japan's industrial production index (1934 - 36 = 100) reached about 88. During the first year the index rose by 50 per cent, and by the end of the second year by another 5 per cent. As will be



Index of Japanese Mining and Manufacturing Activity.

seen in the accompanying chart, it has levelled off at around the 137 mark, compared with an average of 150 for the year 1941, just before Pearl Harbor.

What the chart does not show is that the recovery has been spotty, reflecting partly the great shifts that have taken place in the distribution of Japanese imports and exports. Coal mining, electric power generation, shipbuilding, steel and metal processing, as well as the manufacture of automobiles, cement, glass, paper, and most chemicals, have exceeded their prewar levels. In world shipbuilding Japan now holds second place, reflecting strenuous efforts to rebuild her merchant fleet. On the other hand, the manufacture of textiles, machine tools, soap, rubber, and dyestuffs has yet to recover to the prewar level. Raw silk output is now only about one-fourth of prewar.

Also to be borne in mind is the rapid increase in population, so that on a per capita basis production is still somewhat below the level of the mid-'thirties.

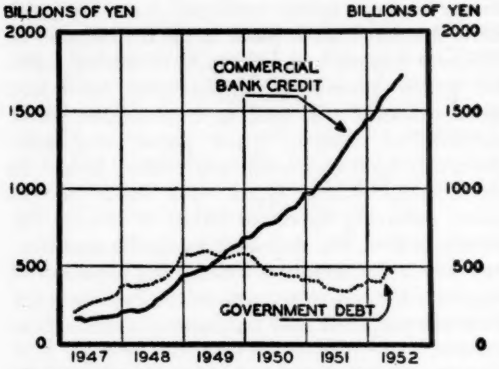
Need for Capital

Looking forward to further progress, one of Japan's great problems is finding capital for the rehabilitation and modernization of her industries.

Contrary perhaps to the general impression, a large share of Japanese industry is characterized by high rather than low-cost production. Costs are low principally in the lighter industries, such as textiles, toys, and light bulbs. In the heavier industries, such as iron and steel, engineering, and equipment — which in the world conditions of today offer the best prospect of finding export outlets as underdeveloped countries seek to promote their own lighter industries — the Japanese are, generally, high-cost producers. Under-mechanization and use of outmoded equipment is still, despite notable exceptions, handicapping large sections of Japanese industry. If Japan is to meet foreign competition and pay her own way in international trade she must bring her industries up to date.

Due both to the magnitude of this rehabilitation and modernization job, and to the effect of inflation in wiping out corporate working capital and national savings, resort was made to heavy borrowing from the banking system. During the first years of demoralized conditions after the war, the Government was forced to supply industry's capital requirements, which it did by borrowing from the Bank of Japan. Later, in 1949, when the Dodge Program put a stop to this, the demand shifted directly to the commercial banks. As will be seen from the

chart below, loans, discounts, and security holdings of the banks have more than doubled since the end of 1949. As a result, Japanese banks as a whole are overloaned, and their liquidity has declined.



Government Debt and Commercial Bank Credit in Japan
Bank credit includes loans, discounts, and securities of all Japanese banks except the Bank of Japan.

Since the tax reforms instituted by the Shoup Mission, providing for upward revaluation of corporate assets more in line with present-day inflated values and allowing more adequate depreciation charges, business is being able to increase its self-financing through retention of earnings.

Establishment of a Development Bank and an Export-Import Bank is designed to reduce demand on the commercial banks for financing long-term equipment purchases. There is a question, however, of how much of a dent they can make in the problem, since these institutions will have to get their capital somewhere.

Thus the problem of obtaining capital remains, and is causing Japan to look again to foreign, and particularly American, sources. Already some of the oil companies have made substantial new investments in Japan. Apart from these, American capital has shown its interest largely in the sharing of "know how" in the form of technological assistance contracts and patent licenses. Some 100 such contracts are reported to have been signed by American firms alone.

Private investment in Japanese industry should be enhanced in the future through the prompt action of the Japanese Government in offering such a satisfactory settlement of its prewar external debts. The Debt Commission headed by Ambassador Juichi Tsushima offered a plan proposing to British and American bondholders the resumption of debt service on some $450 million of outstanding indebtedness on original contractual terms, including all past due interest and subject only to some extension of maturities.

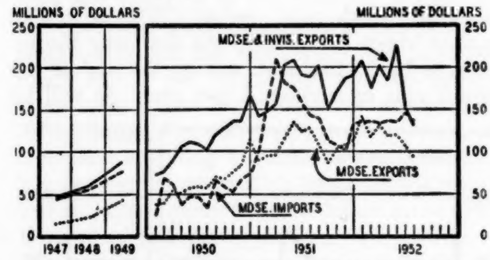
The flow of private foreign capital into Japan will depend on finding a continuing attractive economic climate, including stable money, fair treatment, and ability to make and remit profits.

Some capital contributions may be made by such institutions as the International Bank for Reconstruction and Development which has admitted Japan to membership and is sending a fact-finding mission there.

There is, however, no short cut in the accumulation of capital and most of it must be achieved the hard way by earning it and saving it.

Raw Materials and Markets

A second great problem of Japan is that of adjusting her trade to the loss of her colonial empire. That it has not yet become acute is due to a large extent to American grants in aid and heavy spending by the U.S. military forces in Japan. As indicated by the accompanying diagram, foreign exchange payments for imports have exceeded export receipts in every year save one (1950) of the postwar period; yet when account is taken of all items in the balance sheet, including U.S. aid, the figures show a substantial margin "in the black" which has gone towards increasing the foreign exchange reserves. In 1951, despite termination of formal American aid the net surplus in Japan's international accounts came to about $350 million. Although in the first half of 1952 the net surplus declined, Japan has been able to rebuild her foreign exchange holdings, almost completely dissipated by the end of the war, to the equivalent of nearly $1.2 billion as of June 30 this year, including principally 671 million dollars and 127 million pounds sterling.



Japanese Foreign Exchange Proceeds of Merchandise Exports and Imports and Net Invisible Exports (including U. S. aid, U. N. procurement, and expenditures of U. S. troops)

But this of course cannot be counted on to last. Once the Korean war is ended, and American military spending in Japan slows down, the Japanese must find means to close the international payments gap themselves. This comes back to the question of Japanese dependence on outside sources for food and raw materials.

Before the war, Japan, as the table below shows, was getting about a third of her imports from her empire countries and China, and in return was selling them some 40 per cent of her exports. With the loss of the empire, and with China under Communist domination, these percentages were cut drastically. On the import side, Japan was forced to turn to the Western Hemisphere for many supplies formerly obtained within the empire and paid for in yen. Substantial amounts of such products as coking coal, iron ore, steel, industrial chemicals, salt, sugar, rice, and soybean products now have to be purchased in dollars and hauled across the Pacific largely in foreign bottoms (Japanese merchant marine being still only about half of the prewar size). This not only augments Japanese dollar requirements but adds substantially to Japanese production costs.

Geographic Distribution of Japanese Trade
(Percentage Distribution of Total Value)

	1935-37	1947	1949	1950	1951
IMPORTS					
Former empire and China (a)	33	2	5	10	4
Other Asia	18	4	13	22	28
United States	25	92	64	44	35
Latin America	3	—	2	7	14
Europe	10	2	8	4	8
Others	11	—	8	13	11
Total	100	100	100	100	100
EXPORTS					
Former empire and China	43	17	5	9	5
Other Asia	21	40	45	37	46
United States	16	12	16	22	14
Latin America	4	—	1	6	7
Europe	8	23	16	12	11
Others	8	8	17	14	17
Total	100	100	100	100	100

(a) Former empire includes Sakhalin, Formosa, South and North Korea, Manchuria, and Kwantung.

Source: FEA and SCAP publications; for recent years the publications of the Japanese Economic Stabilization Board.

Meantime, on the export side the increase in Japanese trade has been mostly with the free countries of Asia for which payment is received in inconvertible currencies, notably sterling.

Meeting this situation is partly a question of Japan's being able to produce at attractive prices goods which she can sell to the Western World — and her success in using this method of restoring her trade will of course depend partly on the trade policies of ourselves and other Western countries and our willingness to receive imports. Still more, it would appear, it is a problem of developing non-dollar sources of Japanese imports in Asia and elsewhere. Southeastern Asia, in particular, has great potentialities for supplying Japan with foodstuffs and raw materials, in return for which they will need Japanese light products, electric appliances, various other manufactures, and capital goods.

In any case, success in rebuilding a balanced trade means maintaining stable money and other conditions at home essential to making Japan an attractive place for employment of capital, both foreign and domestic.

That Japan has made progress in effecting the necessary shift in trade is evident from the table. But more needs to be done. Recognizing the possibilities, the Japanese Economic Stabilization Board early this year set aside some $90 million to underwrite private Japanese investments over the next five years in India (iron ore), Malaya (iron ore and bauxite), Siam (salt), Indonesia (coal, nickel, lumber, iron ore), and the Philippines. The development of iron ore resources in India is reported to have started and if Indian transportation facilities could be improved India could also supply much-needed coking coal.

Also, Southeastern Asia has important surpluses of foodstuffs — rice, vegetable oil, and wheat.

Thus many factors favor growth of Japan's trade with these countries. Moreover, she is rebuilding her merchant fleet so she can move a large part of her trade in her own shipping.

But the obstacles are still formidable, including principally the inconvertibility of sterling and the shortage of Japanese investment capital.

Need for Mutual Understanding

This review of Trends in Japan may well conclude with emphasis on two points:

1. Japan has a great potential in terms of economic strength, military capacity, and moral qualities, which can make her a bastion against Communist imperialism.

2. Such a role involves a multitude of economic problems, most of which she must solve herself. But much will depend upon the kind of world we live in — whether it is one of expanding economic activities and increasing freedom of trade, or one of continued obstacles and restrictions.

So many of these problems are shared between Japan and other countries that success in dealing with them depends on all our efforts and achievements in mutual understanding. In some ways the conditions are more favorable than ever. The East is awake to its present dangers as never before. The West is learning to think of other peoples in new terms. This is indeed a good foundation on which to build.

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